Institutional Investors Adjust to Lower Return Expectations

By Justin Mitchell
FUNDfire
April 4, 2022

Institutional investors expect public equities returns to be lower than average this year, but at the same time are confident they can meet their return targets, according to a recent survey by outsourced chief investment officer firm Commonfund.

The survey included 150 “sophisticated” investors who took part in the latest Commonfund Forum in mid-March, including endowments, foundations, charities, pension funds, insurance companies, family offices, registered investment advisors and health care organizations.

Seventy-eight percent of respondents expected U.S. stock market returns for 2022 to be lower than the 10-year average return for the S&P 500. That was a sizable increase from last year, when 58% said the same.

A lot of this pessimism has to do with just how good a year 2021 was for investors, especially foundations and endowments, said Mark Anson, Commonfund’s CEO and chief investment officer.

“When you have such a good year in your rearview mirror, it’s only natural that you take expectations down a bit, … [to think] it’s unlikely we’ll be able to repeat that in 2022, and we agree,” he said. “We do believe returns will be lower this year, and so far, that’s the case.”

At the same time, 56% of respondents said they were “cautiously optimistic” about meeting their investment return targets, with another 23% saying they were “very bullish.” Only 20% said they were “feeling nervous” about meeting their objectives.

Some of the confidence may stem from the “consistent pattern” of higher allocations to private capital, which can provide higher risk-adjusted returns, Anson said.

“The liquidity premium is in fact real. It does exist. It is measurable,” Anson said. Therefore, it is to long-term investors’ “advantage to apply capital in private equity, venture capital and other illiquid assets and collect and gather that illiquidity premium, and more and more sophisticated investors have realized that.”

Private equity was the top asset class investors deemed likely to deliver strong risk-adjusted returns over the next year, cited by 70% of respondents to the Commonfund survey. That was followed by private real assets, selected by 41% of the investors and venture capital, cited by 37%. Public equity came in fourth place, chosen by 29% of respondents.

While it may be necessary for investors to put more money into private markets, they will still always need space in their portfolios for traditional assets, said Chris Scibelli, a managing director at Alpine Capital Research, a boutique public equities manager.

“What we have not seen is many people trying to figure out how to generate better returns from their legacy traditional assets,” he said.

Investors can still get good returns out of the public markets if they adjust their approach, Scibelli said. Instead of focusing on “relative return beta,” or benchmark-like exposures, which are widely expected not to deliver high enough returns, investors should focus on “absolute value beta,” by seeking areas likely to deliver the best possible returns.

By doing this, investors are at least getting an outcome-oriented strategy, Scibelli said.

“At least it’s striving for that vis-a-vis a relative return to it without increasing your lock-ups, or your illiquidity, or your lack of transparency, or your fees and expenses,” he said. “You’re able to get a lot of the benefits of private market alternatives without all the other attendant attributes.”

Some of the investors who expressed concerns about meeting their investment targets may not have “geared up” their private markets portfolios fast enough, Anson said.

Another problem some may face is having an “over-allocation to bonds,” he said.

Rising interest rates are signaling a “new day” for bonds, which brings with it the necessity for investors to change their approach to fixed income investments, said Russ Kamp, a managing director at Ryan ALM, a fixed income manager that works mostly with defined benefit pensions.

Kamp recommends plan sponsors “bifurcate” their assets into one bucket that provides liquidity, which includes fixed income, and another for growth assets intended to provide returns.

“They need to basically take the current fixed income exposure and convert it from a total return focused effort to one that's used to secure the promised benefits,” he said.

Investors should also rebalance their portfolios “systematically,” said Orray Taft, managing principal for Meketa Investment Group, a consultant that works with a wide variety of institutional investors, in an email.

“We also suggest that properly diversified portfolios should be able to withstand these types of environments, and we encourage our clients to focus on their long term goals,” he said.

Back to top